No. 2912.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT.

THE FIRST NATIONAL BANK OF SAN FRANCISCO, et al.,

Appellants,

vs.

DETROIT TRUST COMPANY, et al.,

Appellees.

Upon Appeal from the District Court of the United States for the Western District of Washington, Southern Division.

ADDITIONAL BRIEF ON BEHALF OF APPELLANT THE FIRST NATIONAL BANK OF SAN FRANCISCO

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The undersigned on behalf of the appellant, The First National Bank of San Francisco, beg to submit the following observations in connection with the argument of Messrs. Hughes, McMicken, Dovell & Ramsey in their brief upon this appeal.

We also beg to refer to that brief for the statement of the case and the assignments of error.

We have here an ordinary suit to foreclose a mortgage covering a large tract of timber land and on a separate tract a saw-mill, etc. The land in question is covered by three mortgages: The first mortgage

being that sought to be foreclosed under the plaintiffs' bill; a second mortgage runs to the same parties plaintiffs for $69,000, and for the purposes of our argument may be considered as part of the first mortgage. The third mortgage runs to the First Federal Trust Company and Milton R. Clark to secure an indebtedness of the S. E. Slade Lumber Company to several different creditors. The balance remaining unpaid under this third mortgage is in round figures about $540,000.

When the bill was filed, the court, at the instance of the plaintiffs, appointed a receiver and authorized him to enter into a contract to log off the timber land and dispose of the timber, notwithstanding the fact that the Lumber Company had not been operating the property for a long time, in fact, since prior to the time of the execution of the third mortgage, and during all that time had been at a standstill. The receiver, pursuant to the authority of the court, entered into a contract to log off and sell the timber.

The mortgage sought to be foreclosed originally secured an indebtedness of $1,000,000 (Tr., p. 19), of which $450,000 was paid prior to the filing of the bill (Tr., p. 24), so that the indebtedness now secured by the mortgage is slightly over half of that originally secured. The mill properties alone are shown to have been appraised at approximately $400,000 (Tr., p. 96). It is not claimed that there is any inadequacy of security for the payment of this first mort-

gage, and yet the court, through its receiver, proposes, at the instance of the first mortgagees, immediately to engage in the business for which the Lumber Company was organized, so far as the matter of logging and selling its timber is concerned, thus embarking upon an operation which, in the ordinary course of business, will continue for several years. Indeed if the property is logged at the rate of 50,000,000 feet per year (Tr., p. 106), as the stand of timber amounts to upwards of 500,000,000 feet (Tr., p. 152), we have a business to be carried on by the receiver which may cover a period of at least ten years.

It will be borne in mind, too, that the order appointing the receiver and granting to him these extensive and extraordinary powers, was made without notice to the trustees representing the third mortgage, and without any application on their part, and, as the record shows, at a time when no creditor secured by the third mortgage was seeking its foreclosure. These orders were made, so far as the appellants here are concerned, *ex parte*, and without any notice to them. As soon as the matter was brought to their attention, they took steps to have the orders withdrawn, and upon an adverse ruling being finally made, have prosecuted this appeal.

The case to our minds is a simple one involving, only, questions as to the power of a court of equity

in a foreclosure case, and as to the discretion with which that power is to be exercised.

As we understand it, the power of a court to appoint a receiver finds its roots in the necessity of protecting the interests of those concerned in the property by maintaining, so to speak, its *status quo*. So that, as has been said, it may be preserved for those entitled to it. In a foreclosure case where the mortgage security is adequate, the mortgagee ordinarily has no right to have a receiver appointed for the purpose of collecting rents, issues or profits, for the simple reason that he is adequately protected by his mortgage interest in the corpus of the property. Such is the case here, so far as the first mortgagee is concerned, and it must be remembered that it is at the instance of the first mortgagee that the receiver was appointed, and that thus far no other mortgage is sought to be foreclosed in this proceeding. Even if it be assumed that the subsequent mortgagees will appear and seek foreclosure of their liens, such assumption affords no ground for the present appointment of a receiver to operate the properties. It may be argued that in such a case as we have here, even though the security for the payment of the first mortgage be adequate, a receivership is necessary on the ground that there are no funds for the payment of taxes, or for the protection of the property by way of insurance, etc. A complete answer to such suggestion is found in the fact that the mortgagees under

the first mortgage have the right to pay such sums as may be necessary for these purposes, in which event they shall constitute a first lien on the property.

The Lumber Company ceased logging in May or June, 1914 (Tr., p. 280), and the mortgage securing the demands of appellants was executed about a year later (Tr., p. 168).

In these circumstances, as the first mortgage is more than adequately secured, and as the property was at a standstill when the third mortgage was taken, we submit that there is no warrant for the court to engage through its receiver in the business of logging. Indeed there is, we submit, no occasion whatever for the appointment of a receiver in this case.

But, in any event, we submit that the court has no power to authorize its receiver to commence business for the corporation, and thus impose new contractual obligations upon the parties, which they have not made for themselves. The power of the court, we take it, is measured by the requirements of the situation with respect to the preservation of the property, and does not go beyond that, and, as we have shown, there is ample power in the first mortgagees to protect this property without the aid of the court.

There are cases in which courts have, in foreclosure suits, authorized receivers to operate properties, but these very cases lay down the limits of the power of the court so clearly and limit the power so closely to the classes of cases in which it has been

exercised, and of which the case at bar is not one, that we think there is no difficulty in showing, from a few authorities, that the court exceeded its power in making the orders complained of here. The only cases in which receivers have been authorized to operate properties will be found to be cases where the property was in operation at the time of the receivership, and where the cessation of the business, whatever it was, would itself be destructive to the value of the property involved. The principal cases in which receivers have been authorized to carry on business for going concerns are those involving the operation of railroads, and in such cases, as is well known, the maintenance of the business as a going concern is justified in the interests, not of the parties litigant, but of the public. It is familiar knowledge that in many of such cases, perhaps in most of them, the operation by the receiver results in added burdens of debt against the property. As said by Mr. Justice Miller in his dissenting opinion in *Barton* vs. *Barbour,* 104 U. S., 126, 138, 26 L. ed., 672, 678:

> "He [the receiver] . . . sometimes, though very rarely, pays some money on the debt of the corporation, but quite as often adds to the sum of these debts, and injures the prior creditors by creating a new and superior lien on the property pledged to them."

Perhaps the leading case in this circuit is *International Trust Co.* vs. *Decker Bros.,* 152 Fed., 78. In

that case a receiver was appointed for a corporation owning certain mines, which had been mortgaged to secure a bond issue, and was authorized by the District Court to operate the mines, and for this purpose to issue receiver's certificates. The action was brought by a general creditor, alleging that the corporation was insolvent. After the receivership and such operation of the mines had continued for a period of more than eight years the District Court made an order of sale directing that all the properties be sold as an entirety. An appeal was prosecuted by the mortgagee from this order of sale. The opinion refers to the practice incident to railroad receiverships, whereby railroads are operated by receivers, and proceeds upon a full review of the authorities to hold that such practice has no application to corporations engaged in strictly private enterprises. The review of authorities in this opinion is so complete and the rule is therein stated with such finality by this court itself, that we are sure the court will prefer to examine the opinion itself, rather than any statement thereof that we might make.

In the case just referred to, the court refers with approval to *Dalliba* vs. *Winschell,* 11 Idaho, 364; 82 Pac., 107; 114 Am. St. Rep., 267, which is described in the opinion as "a very late and well-considered case." In that case the court said, 82 Pac., p. 109; 114 Am. St. Rep., 272:

> "But for the court to go beyond the protection and preservation of an ordinary placer mine and assume to enter into mining operations and the running and conducting of a mine, as appears to have been done by the receiver in this case, is outside of the line of duty of courts of equity and of their receivers, and *this excessive exercise of jurisdiction* becomes dangerous when indebtedness thus incurred supplants prior existing mortgages and obligations upon the property." (Italics ours.)

This court, in its opinion in the International Trust Company case, *supra,* said that eight years is too long for a court to hold a mining property in its custody, a view which seems particularly applicable to the situation here, for the contract made by the receiver in this case may continue the operation of the property for a period of upwards of ten years. The order of sale, obtained by the general creditor in that case, was reversed on the ground that full value of the property could be obtained only by foreclosure of the mortgage.

In the case at bar the order appealed from gives the receiver "full power to manage and operate all "or any part of the properties covered by said mort- "gage or deed of trust, either by logging contract or "otherwise, as he may deem advisable," and also authorizes the receiver to enter into a contract for the logging of the timber. This, of course, is not for the purpose of taking care of and saving the property, for it amounts to an order of sale of the

whole mortgage security, not pursuant, however, to any decree of foreclosure. The standing timber, and not the lands, constitute the mortgage security. The order is therefore subject to the same infirmity that was found in the order reversed in *International Trust Co.* vs. *Decker Bros.,* that is, the only proper sale here, as there, is a sale pursuant to a proper decree of foreclosure.

Besides, it is submitted that the order appealed from goes away beyond the effect of an order authorizing the receiver to carry on the business of a going concern inasmuch as it permits the business to be initiated and continued by the receiver for a period of years. In other words, the business is not to be "carried on" to "protect and preserve the property," but is to be newly entered into and continued until the resources are exhausted to an extent sufficient to pay off plaintiffs' mortgage. This of course, is quite different from continuing a business *pendente lite* in order to keep it a "going concern." The order is without any precedent and squarely conflicts with the fundamental rule that a receiver of a private corporation in a foreclosure suit cannot in any event be given power to do aught but protect and preserve the property until a sale can be had pursuant to a proper decree of foreclosure.

In *First Nat. Bank* vs. *Cook,* 12 Wy., 492; 76 Pac., 674; 2 L. R. A. n. s., 1012, the court in proceedings in aid of execution appointed a receiver, who took

charge of a cattle ranch and other property already covered by mortgages. The court (2 L. R. A. n. s., p. 1025) cited with approval from another case the following language:

> "A mortgage is a contract obligation, and it is as sacred as any other contract; and anything that destroys or impairs its lien destroys or impairs a contract. The reason that supports the excepted cases of railroads and some other business properties is that, they being charged with a duty to the public that is superior to any private obligations, the mortgage owner has knowledge when he invests that his security is liable to be displaced in favor of that first obligation. In no well-considered case that we know of has the power been exercised to the subversion of the rights of a prior mortgagee of purely private property, unless for very peculiar reasons."

In the note to this case, 2 L. R. A. n. s., 1063, it is said:

> "The general rule is that a court of equity is not authorized to engage in carrying on business of private corporations and partnership affairs; . . ."

In *Wiggins* vs. *Neversink Light & Power Co.*, 93 N. Y. Supp., 853, the Supreme Court of New York held:

> "In the case of corporations engaged in a public service, like railroad, water and lighting companies, and which service cannot be interrupted without inconvenience and harm to the community,

courts of equity authorize its receivers of such corporations to issue certificates of indebtedness to raise money to do repairs or obtain supplies to keep the service going, and make such certificates prior liens to the mortgage indebtedness.

But in the case of corporations not engaged in such a service, there is no such practice. It is justified only on the score of public necessity, and even when so exercised has become a great abuse and wrong to mortgage bondholders in many instances, as we all know." (Italics ours.)

In *Farmers' Loan & Trust Co.* vs. *Grape Creek Coal Co.*, 50 Fed., 481, it was held that a receiver could not be authorized to carry on the business of a private corporation against the opposition of twenty-five per cent. of its bondholders.

In that case the receiver of a coal mine, together with the holders of seventy-five per cent. of the bonds secured by a mortgage upon the property and the corporation mortgagor, joined in a request for an order authorizing the receiver to issue certificates, and to continue the operation of the mine. The court reviewed the authorities, pointed out the difference between the principles applying to railroad corporations and concerns affected with a public interest, and said, p. 482:

"Private corporations owe no duty to the public, and their continued operation is not a matter of public concern. It is only against railroad mortgages that the Supreme Court of the United States has sustained orders giving priority to receivers' certificates representing particular indebtedness,

and, as already stated, then only on principles having no application to a mortgage executed by a private corporation owing no duty to the public."

And again, p. 483:

"The court is not asked to subvert the lien of the mortgage on the ground that the trustee or bondholders have got possession of anything which, in equity, belongs to general creditors. It is to enable him to operate the mines for the benefit of bondholders, against the wish of part of them, that the receiver desires to be invested with authority to issue certificates which shall be a prior lien upon the property embraced in the trust deed. Extensive as are the powers of courts of equity, they do not authorize a chancellor to thus impair the force of solemn obligations and destroy vested rights. Instead of displacing mortgages and other liens upon the property of private corporations and natural persons, it is the duty of courts to uphold and enforce them against all subsequent incumbrances. It would be dangerous to extend the power which has been recently exercised over railroad mortgages, (sometimes with unwarranted freedom), on account of their peculiar nature, to all mortgages. The power does not exist, and the application is denied."

The views of the learned court in the case just cited are particularly applicable to the case at bar, and it will be observed that the court there held that it had no power to go into the business of coal mining as against the interests of even a part of the mortgagees. So we contend that here the court has

no power to go into the business of logging off this property.

Even if it were a matter of discretion, we submit that it would be an abuse of discretion to authorize such a contract.

Whatever discretion may be lodged in the trial court with respect to authorizing a transaction such as that involved here, it is clear that the order in question is not a proper exercise of such discretion. It is not claimed by the plaintiffs that they are not adequately secured by their mortgage. In other words, the making of this contract by the receiver is altogether unnecessary insofar as the satisfaction of plaintiffs' mortgage is concerned. It is evident that the ordinary foreclosure sale will result in their being paid in full. In these circumstances it is clear that the court had no discretion to approve the contract in question.

As is said in *High on Receivers,* Sec. 667, pp. 819, 820:

> "And by inadequacy of security, within the meaning of the rule, is to be understood inadequacy as to the particular mortgage which is being foreclosed, and not as to other and subsequent mortgages."

What plaintiffs are trying to do is to pay off their mortgage by the unique method of bringing a foreclosure suit, but staying the foreclosure sale while in the meantime, although they must concede that

their security is adequate, a receiver, appointed at their instance, denudes the land of its timber, thus applying the real value of the property to the payment of the first mortgage lien, and leaving the almost worthless bare lands as security for the subsequent mortgages.

Such procedure, we submit, will not be permitted by this court.

It is respectfully submitted that the orders appealed from should be reversed.

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Solicitors for appellant, The First National Bank of San Francisco.